

The preceding failures may or may not be actual failures. The pattern did not carry through as expected and there were no further trend legs, but in many cases like those it will be possible to take profits at the first target. Once these profits are booked and risk is reduced, it becomes very likely that the trade will be breakeven at worst. However, not all Anti failures are this polite; Figure 10.37 shows an example of a failure that would likely have resulted in a full-sized loss on the trade.

After a protracted downtrend, the USDCHF bounced and set up a potential buy Anti. (Again, this is not a perfect example of a buy setup, as the setup leg did not display a strong change of character.) Long positions entered at A would have likely suffered full losses as the market turned back down and traded through stops around B. Further stops, located beyond the trend low, would also have been quickly hit in the ensuing downswing.

Though the Anti is a powerful pattern that sets up excellent trades, there are also some dramatic failures. There are even cases, not shown here, in which the market gaps dramatically against the position on the next open, resulting in a loss beyond the initial risk point. Do not focus only on positive outcomes. When you enter a trade, your attention should be on potential failures and on signs that the pattern can be failing. Failed patterns can often be more powerful than successful trades, and patterns often fail through other tradable patterns. Revisit the failure in Figure 10.35; is this a complex pullback? These patterns are far more than mere trade setups or entry triggers—they are a complete methodology for understanding market movements.

Conclusions

At first glance, the Anti might appear to be nothing more than a pullback—the market makes a sharp move, and, after a pause, another move in the same direction. However, the distinguishing factor is the location in the market structure, which allows traders to position near the end of one trend and the potential beginning of another; if the trade is correct, it will benefit from trapped traders scrambling to adjust their positions into the new trend. This pattern, with its precisely defined entry and risk points, is a powerful tool to play inflections and turning points in trends.

TRADING AT SUPPORT AND RESISTANCE

Trades made at support and resistance are plays for those levels either breaking or holding. To further simplify, breakouts are trades *through* support or resistance levels, while failed breakouts are trades that indicate the level is more likely to hold. Note that there is some potential overlap here: a failure test is a failed breakout, but it is usually a question of time frames. A failure test on the trading time frame will usually show one of the following section's failed breakout patterns on lower time frames. A good understanding of the ways in which breakout patterns unfold can add a valuable piece to the trader's analytical tool kit.

Breakouts: Early Entry in Base

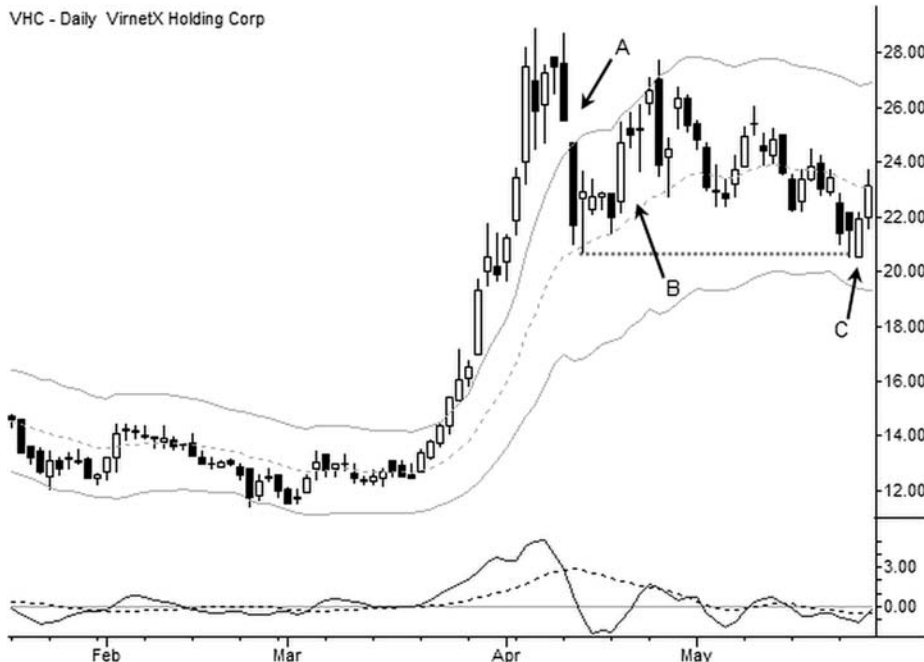


FIGURE 10.38 Buying a Spring at Support in VHC

Setup After a long run-up, VirnetX Holding Corporation (AMEX: VHC) rolled over into an extended consolidation, as shown in Figure 10.38.

A: The initial downswing, at A, might have set up a sell Anti.

B: However, at B, buyers stepped in and it became clear that there would be no easy downward momentum; the stock then traded in a multimonth range near the previous highs. This type of consolidation often sets up an attractive breakout trade, but the problem is finding a precise entry and managing the risk in the trade.

Entry One way to enter a breakout trade is to recognize the pattern setting up, and enter in anticipation of the breakout.

C: In this case, a failure test of the previous pivot at C offered an attractive entry. Note that this is a classic Wyckoff spring, though the best examples of springs should penetrate previous support more decisively.

Stop Initially, this entry is nothing more than a failure test at the previous pivot. The appropriate stop is just beyond the low of C, but the issue of potential slippage and a gap opening must be considered. One answer is to accept both of those risks as normal

trade risks and to trade full size. It is also possible to initiate a smaller position near this low, planning to add to the trade later or to set the stop slightly lower. All of these are legitimate answers to these issues, but this question must be clearly addressed in the trading plan.

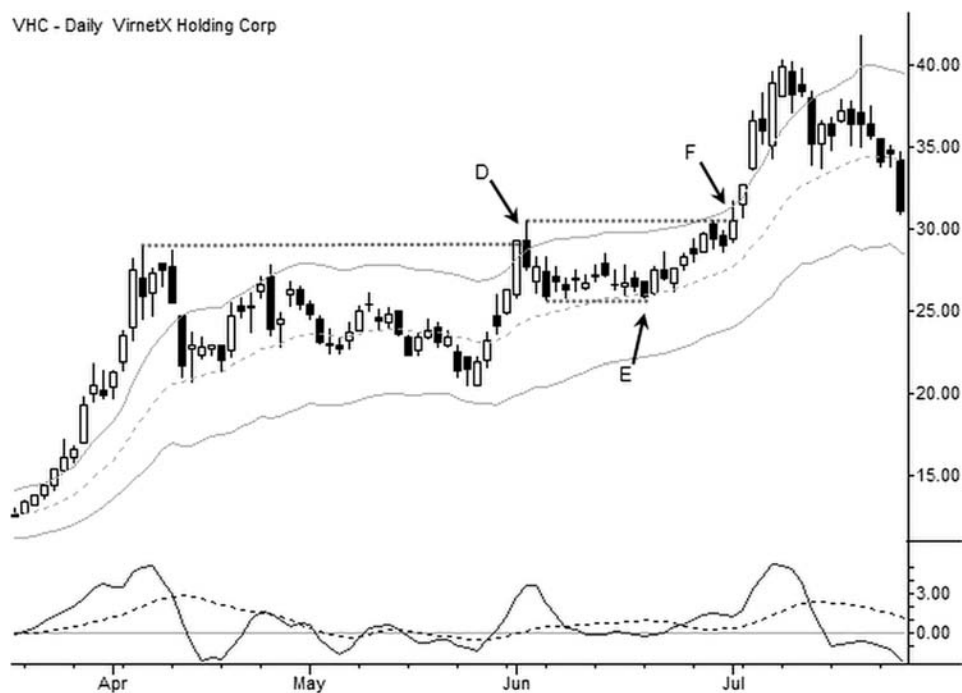


FIGURE 10.39 A Complicated Winning Breakout Trade

- D: The stock immediately reversed off the spring and traded sharply back to highs in Figure 10.39. D marks the actual breakout, which failed on this attempt. Consider the difference between initiating a position at C or at D. The trader who enters at D is now in a position of weakness and must exit the position, while the trader who entered at C is holding substantial profits and has many more trade management options available. Will you exit part or all of the position on the failure, taking profits and looking to reestablish? Will you add to your position at D and then adjust it if the trade fails? Will you do nothing? These are all choices available only to the trader who positions somewhere near the bottom of the range.
- E: The stock holds a tighter consolidation up against resistance. E is a small spring, and may not be a realistic entry as it penetrates previous support by only a few cents.
- F: The actual breakout comes at F, as the stock finally clears resistance and trades sharply higher.

Conclusions Entering early in the base preceding a breakout is one way to sidestep the volatility and issues around the actual breakout point. Failure tests, lower time frame Antis, and small pullbacks call can offer attractive entry points within the range. If using some of these patterns, it may make sense to adjust the stop to respect the limits of the higher time frame pattern. In other words, if positioning in a daily range using a 30-minute Anti, perhaps set the stop outside the daily range. This will result in a much smaller position size, but it will be a position size that respects the reality of the higher time frame market structure.

This example also raised the possibility of adding to an existing position. This is a good plan in many cases, but it also makes sense to aggressively adjust the position if that second entry fails by exiting *more* than was added. In other words, if you were holding 5,000 shares from C and added 2,000 at D, you would exit *more* than 2,000 on the failure of D. Though it is difficult for some traders to maintain the discipline of a rule like this, it will add consistency to the bottom line.

Breakouts: First Pullback Following

A word on terminology: stock traders tend to use *breakout* for upside breakouts through resistance and *breakdown* for entries through support; futures traders are more likely to call both trades breakouts. Since all trade entries are more or less symmetrical, I have opted to simplify and to use *breakout* for both trades.

Setup

A: This example was deliberately chosen because it is much less clear than a textbook example. JPM had just come off a strong two-quarter uptrend (not visible in Figure 10.40), and seemed to be setting up for a further advance. Traders would have been justified in attempting to buy springs at support, as in the previous example. However, there are at least two important differences between this example and the best examples of long setups: One, successive bounces off support terminate at lower price levels—smaller upswings suggest that buyers may be losing conviction. Two, at point A price dropped cleanly below previous support.

Entry

B: Again, it would have been reasonable to be looking for a long entry on a failure test following A, as the third bar following traded strongly back above support. However, there was no upside momentum, and the market rolled over into a pullback at B. Though this proved to be the ideal entry in the breakout, it was extremely difficult to see this entry at the time; there was at least one other clear entry later.

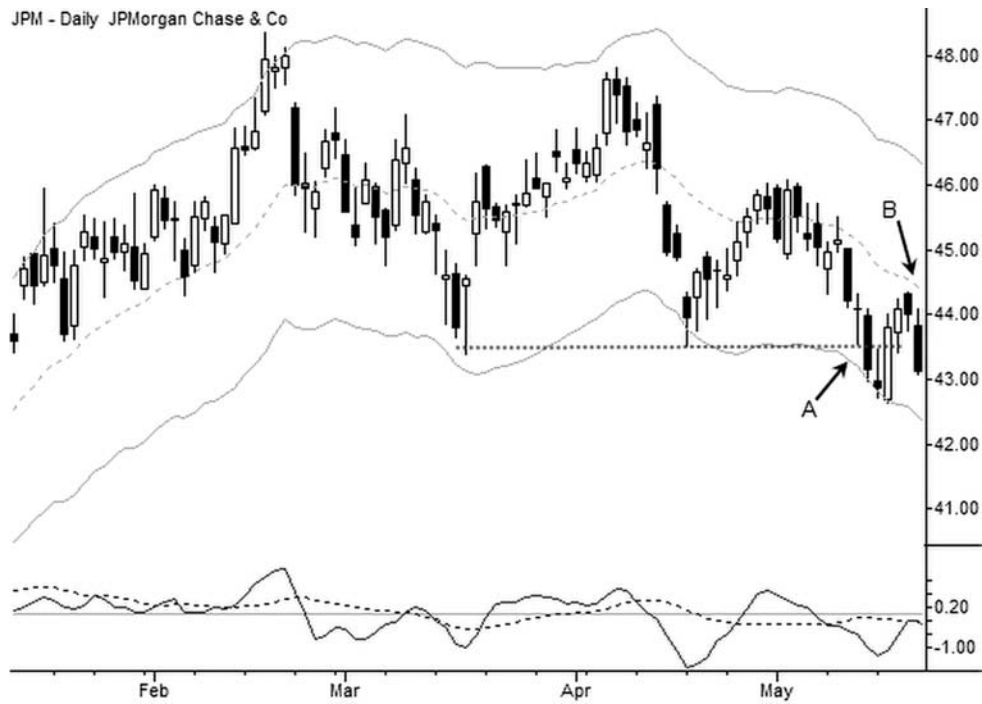


FIGURE 10.40 A Complicated Breakout Trade in JPMorgan Chase & Company (NYSE: JPM)



FIGURE 10.41 A Downtrend Follows a Downside Breakout

- C: The entry at B, though obvious in retrospect, was much harder in real time. The entry at C in Figure 10.41, though, was a simple pullback and could have been traded like any other pullback. There is an important lesson here: Simple technical patterns become more powerful when they are put in context of bigger-picture market structure. In this case, the failure of the potential upside consolidation through a downside breakout could be expected to lead to several trend legs down. Taking bearish pullbacks in those conditions would have been an excellent trade.
- D: This is probably the ideal exit for a trader looking to take one clean swing out of the market. A failure test at lows, on the third attempt to make new lows, tilted the probabilities slightly against the bears. In this case, the stock traded lower, but after more than a month of sloppy consolidation. Find the best trades, the cleanest trades, for that is where your mental and financial capital can best be deployed.

Conclusions Another lesson here is that there is nothing magical about the breakout level. The pullback following breakouts can violate the pullback level (as B did in this example), can stop at the level, or can hold well clear of the level. In each case, price action is far more informative than the market's relation to a specific price level.

Breakout Failures

There are three common breakout failures. None of them need extensive analysis at this point, because they are pattern failures we have already considered elsewhere. However, for traders focusing on breakouts, it is important to have these possibilities in mind and to be prepared to manage the risk as the trade evolves.

At Breakout Point (Failure Test)

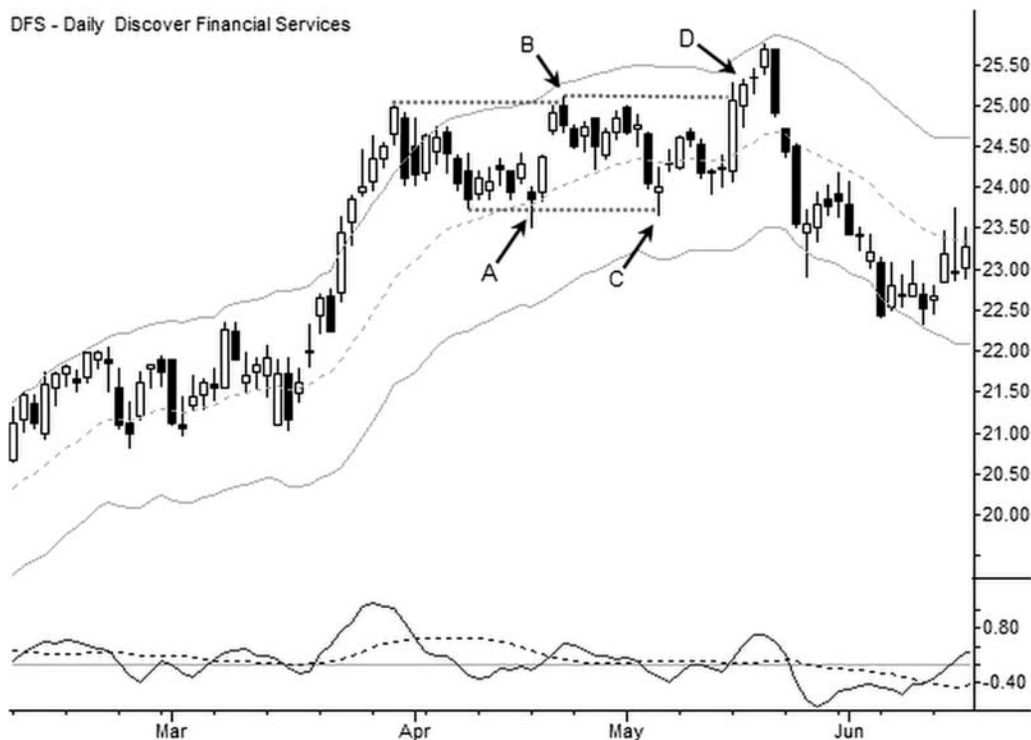


FIGURE 10.42 A Breakout Failure in Discover Financial Services (NYSE: DFS)

This failure pattern, shown in Figure 10.42, is nothing more than a failure test at the potential breakout level. (We could say that a failure test is a failed breakout.) A and C are classic springs (which are themselves downward breakout failures); each would have been an excellent entry for the potential upside breakout. There are also two failed upside breakouts here. B is a small failure test at the highs, and D is a large-scale failure.

These failures can be dramatic and they demand respect. Breakouts often encourage large groups of traders to enter overextended markets; the reversals from failures at these points can be violent. Note that the breakout may fail on the same bar or a few bars following the actual breakout. The main challenge here is differentiating between a normal breakout pullback, which may or may not violate the breakout level, and a more decisive failure.

At First Consolidation The first pullback following a breakout is often an excellent spot to enter a trade. If the breakout works and a longer trend develops, this entry will have been right at the inception of the new trend. However, there is still a possibility of a failed breakout, which, in this case, will fail through a failed pullback. Deep study

and familiarity with all the variations of pullbacks and their failure patterns will help the trader to manage these potentially complex trades.

One point to consider is that these initial postbreakout pullbacks are rarely complex pullbacks. In general, simple pullbacks are a sign of some urgency in the trend, while complex pullbacks are needed to work off possible overextensions in further trend legs. In the best breakout examples, a strong trend will quickly follow and this strong trend will not generate complex pullbacks early on. Traders can trade these postbreakout pullbacks with fairly tight stops (not referring to the breakout level, but to the geometry of the actual pullback pattern) and usually need not consider the possibility of a complex pullback.

Failure in Base Last, though entering in the base preceding a breakout has many advantages, there is one important problem—the breakout may never happen. For instance, buying in anticipation of an upside breakout in Figure 10.40 would have been a perfectly reasonable trade, but it would have been a losing trade. There is an eternal trade-off between confirmation and trade location. A trader positioning early has excellent trade location, but perhaps with a lower probability of the trade actually working. Traders waiting for the actual breakout often find themselves in a position of weakness because of poor trade location, but with a higher probability of the trade working.

It is possible to trade any of these patterns according to many different plans. The key, in all cases, is that the plan is clearly articulated and that it focuses as much on how to manage losing trades as on where to take profits.

SUMMARY

This chapter has presented many examples of the trading templates from Chapter 6. Though much deeper analysis was possible in every case, most of the comments focus on the most important and most repeatable elements of these patterns. These are not examples and models to be followed slavishly, but nearly all traders will find they can adapt these ideas and concepts to their own styles and techniques. In particular, the broad ideas for managing exposure in developing trades and for clearly defining the risk for all initial trade entries are nearly universal to all markets, time frames, and trading styles.